[JOINT COMMITTEE PRINT]

DESCRIPTION OF ENERGY TAX BILLS
(S. 1193, S. 1237, S. 1303, and S. 1305)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY AND
AGRICULTURAL TAXATION

OF THE

SENATE COMMITTEE ON FINANCE

ON JULY 18, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

JULY 15, 1983

U.S. GOVERNMENT PRINTING OFFICE
22-736 O WASHINGTON : 1983 JCS-32-83

J862-33
S362-29

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INTRODUCTION

The Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance has scheduled a public hearing on July 18, 1983, on four energy-related tax bills: (1) S. 1193 (relating to percentage depletion treatment of decarbonized phosphate rock), introduced by Senators Symms and McClure; (2) S. 1237 (relating to the definition of geothermal energy for purposes of the energy tax credits), introduced by Senator Baker for Senator Symms and others; (3) S. 1303 (relating to a tax credit for ground water heat pumps), introduced by Senator Mitchell; and (4) S. 1305 (relating to the extension and expansion of renewable energy source tax credits), introduced by Senator Packwood and others.

The first part of the pamphlet is a summary of the bills. This is followed in the second part by a description of present law and related background information. The third part describes the four bills scheduled for hearing.

I. SUMMARY

Present Law

Percentage depletion

In the case of natural deposits (such as mines or geothermal deposits), taxpayers are allowed an annual deduction for depletion. Taxpayers are entitled to cost depletion but are required to take deductions for percentage depletion if percentage depletion results in a larger deduction.

Under present law, the decarbonization of phosphate rock through the application of thermal processes is not an allowable mining process. Thus, the income attributable to decarbonization is not subject to percentage depletion.

Energy tax credits

In general, the 10-percent business energy credit expired at the end of 1982. However, the general 10-percent business energy credit will continue through 1990 for certain types of property that are part of a long-term project, if certain affirmative commitments are made in connection with the project. Business energy credits (other than the general 10-percent credit) are allowed through 1985 for solar, wind, geothermal, ocean thermal, and qualified hydroelectric generating property. Individuals are allowed a residential energy credit for investments in renewable energy property, including solar, wind, or geothermal property. The residential energy credit will terminate after 1985.

Summary of the Bills

S. 1193

The bill would provide that the application of thermal energy up to 850 degrees Celsius would constitute a mining process with respect to phosphate rock. Income attributable to this process would, therefore, be subject to percentage depletion.

S. 1237

S. 1237 would provide percentage depletion for all geothermal resources, without regard to the temperature at which such resources are stored. The bill would also extend the scope of the residential energy credit and the business energy credit to allow the credit for property using energy sources that are ineligible under present law.

S. 1303

S. 1303 would amend the definition of solar energy property to include heat pumps that use solar energy stored in ground water.

The modified definition of solar energy property would apply for purposes of the residential and the business energy credits.

S. 1305

S. 1305 would extend the residential and business energy credits for solar, wind, or geothermal energy equipment through 1990. The business energy credit would also continue to be available for ocean thermal property, qualified hydroelectric generating property, biomass property, and cogeneration property. Property eligible for the extended credits under the bill would continue to be eligible for the credit through 1995 under new affirmative commitment rules applicable to short-term projects, as well as long-term projects. The bill would also make the regular investment credit available for solar or wind energy property and cogeneration equipment that does not qualify for the regular credit under present law. The bill would repeal the limitation applicable to cogeneration equipment on the use of oil or natural gas. In addition, the scope of the definition of qualified fuel used in biomass property would be expanded to include methane-containing gas produced by anerobic digestion from nonfossil waste materials at certain facilities.

The definition of "geothermal deposits" would be amended to lower the temperature requirement from 122 degrees Fahrenheit to 104 degrees Fahrenheit.

II. PRESENT LAW AND BACKGROUND

Percentage Depletion Under Present Law

In general

In the case of natural deposits (such as oil and gas wells and mineral deposits), taxpayers are allowed an annual deduction for depletion. The depletion deduction is based on the theory that the extraction of resources gradually exhausts the taxpayer's capital investment in the natural deposit.[1] Under present law, subject to the limitations and restrictions (described below), taxpayers who are entitled to cost depletion are required to take deductions for percentage depletion if percentage depletion results in a larger deduction. Percentage depletion is computed by applying a statutory percentage to the gross income from the property for as long as the natural deposit is productive. Although percentage depletion is unrelated to the taxpayer's capital investment in the property, the theory of the allowance for cost depletion is equally applicable to percentage depletion.[2]

Oil and gas

For oil and gas, the Tax Reduction Act of 1975 denied percentage depletion to integrated oil companies, limited percentage depletion for other taxpayers to 65 percent of taxable income, and limited percentage depletion to the income from up to 1,000 barrels a day of production. Under a restriction applicable to all depletable resources, percentage depletion on any property is limited to 50 percent of the taxable income from the property (determined without regard to the depletion deduction).

Geothermal deposits

Prior to the Energy Tax Act of 1978, it was unclear whether the production from geothermal resources qualified for percentage depletion. In *Reich* v. *Commissioner*,[3] the Ninth Circuit held that steam from geothermal wells entitled the taxpayers to percentage depletion deductions. The Ninth Circuit's decision was based on findings that steam is a gas and that the geothermal wells were exhaustible. However, the Internal Revenue Service declined to follow this decision in cases arising outside of the Ninth Circuit.

The Energy Tax Act provided percentage depletion for geothermal deposits located in the United States or its possessions. A geothermal deposit is defined as "a geothermal reservoir consisting of natural heat which is stored in rocks or in an aqueous liquid or

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[1] *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308 (1956).

[2] Section 613 of the Code provides that percentage depletion is unavailable for inexhaustible resources such as minerals from sea water or air.

[3] 454 F.2d 1157 (9th Cir. 1972).

vapor (whether or not under pressure)." The 50-percent-of-taxable-income limitation applicable to percentage depletion for all resources is applicable to geothermal deposits.

Hard Minerals

In the case of hard minerals that are subject to processing after extraction, the Code provides specific rules for determining when mining ceases and manufacturing or refining begins. These rules are necessary to assure that integrated miner-manufacturers do not gain a competitive advantage over non-integrated miners by claiming percentage depletion on income attributable to manufacturing or refining operations.

In the case of phosphate rock, mining includes not merely the extraction of ores or minerals from the ground, but also certain treatment processes to such ores carried out by the mine's owner or operator. In general, these treatment processes include those processes, such as sorting, concentrating, sintering, and substantially equivalent processes, applied to bring the ore to shipping grade and form, and loading for shipment. However, unless otherwise allowed, mining processes do not include calcining, thermal or electric smelting, refining, treatments which effect chemical changes in the ore, or which work by thermal action. Such processes are generally not subject to characterization as mining processes because they alter the chemical nature of the ore and, therefore, are considered to begin the manufacturing process.

Under present law, the sintering and nodulization of phosphate rock is a treatment process which is treated as mining. Sintering is the process of heating an aggregate of fine metal particles at a temperature below their melting point so as to cause them to weld together and agglomerate. Thus, sintering phosphate ore will cause it to nodulize. Sintering and nodulization may be used to agglomerate phosphate rock fines in order to produce an acceptable electric furnace feed in the production of elemental phosphorus. It does not involve a chemical change in the ore itself.

Phosphate rock may be subject to a variety of processes after removal from the ground to bring the phosphate to commercial concentration. These include washing, screening, classifying, floating, and heating. The processes which must be applied to particular production depend upon the quality of the rock mined. For example, a great deal of phosphate rock produced in Florida is already highly concentrated and does not need to be heated. A great deal of North Carolina and Western States production, however, is highly carbonaceous and must be heated to be brought to the same grade as Florida production. The cost of producing and marketing North Carolina and Western States phosphate is, therefore, higher than the cost of producing and marketing Florida production. Another source of phosphate for U.S. consumption is Morocco. "

Decarbonation (or decarbonization) is the process of removing carbonaceous materials from ore, generally through the use of thermal action. Under present law, decarbonation of trona is an allowable mining process, even though decarbonation of trona by thermal action may result in the release of bound water and carbon dioxide, resulting in a chemical change in the trona. There-

fore, percentage depletion on trona is based on the value of soda ash extracted from it.

Phosphate ore may also be decarbonized through the application of thermal energy. However, the heat necessary to decarbonize phosphate rock is in excess of the heat necessary to sinter such rock and may effect a chemical change in the rock. In Rev. Rul. 74-519, 1974-2 C.B. 182, the Internal Revenue Service held that the decarbonation of phosphate rock is a thermal process used to refine a partially processed mineral, which does not qualify as a mining process for percentage depletion purposes. See also Rev. Rul 72-473, 1972-2 C.B. 284.

Energy Tax Credits Under Present Law

Residential energy credits

Individuals are allowed a 40-percent credit of up to $4,000 for expenditures for renewable energy source property, including geothermal energy property and solar energy property. The individual credit for renewable energy source expenditures applies to expenditures made through 1985. There is a credit carryover provision that allows unused credits to be carried over to subsequent taxable years (but not to any taxable year beginning after 1987).

Congress has not approved a residential energy tax credit for a heat pump.

Geothermal energy property.—Under Treasury regulations, renewable energy source property includes equipment (and parts solely related to the functioning of such equipment) necessary to transmit or use energy from a geothermal deposit.

For purposes of the residential energy credit, a geothermal deposit is defined as a geothermal reservoir consisting of natural heat, which is from an underground source and is stored in rocks or in an aqueous liquid or vapor, having a temperature exceeding 122 degrees Fahrenheit. The applicable regulations also provide that equipment that serves both a geothermal function and a non-geothermal function does not qualify as geothermal energy property. However, the existence of a backup system designed for use only in the event of failure of the geothermal energy property would not be disqualifying.

In accordance with the applicable Treasury regulations, in Revenue Ruling 81-304,[4] the Internal Revenue Service ruled that a ground water heat pump that uses well water with a temperature of 56 degrees Fahrenheit as an energy source does not qualify as geothermal energy property for purposes of the residential energy credit.

Solar energy property.—Individuals are allowed a residential energy credit for amounts expended to install solar or wind energy property in connection with a principal residence located in the United States. Treasury regulations define solar energy property as equipment that, when installed in connection with a dwelling, transmits or uses solar energy to heat or cool the dwelling or to provide hot water for use within the dwelling. For this purpose, solar energy is energy derived directly from sunlight. The regula-

[4] 1981-2 C.B. 7

tions provide that property that uses an energy source that is indirectly derived from sunlight (such as fossil fuel, wood, or heated underground water) is not considered solar energy property.

In Rev. Rul. 81-304, the Internal Revenue Service ruled that a ground water heat pump that uses well water as a source of energy to heat the taxpayer's principal residence does not qualify as solar energy property because the energy in the ground water is indirectly derived from sunlight.[5]

Business energy credit

General rules.—Prior to 1983, the law provided a general 10-percent investment credit for certain energy property (in addition to the regular investment credit). Property eligible for the general 10-percent energy credit includes alternative energy property (which includes ocean thermal or geothermal property), solar and wind energy property, specially defined energy property, recycling equipment, shale oil equipment, equipment for producing natural gas from geopressured brine, and cogeneration equipment. The general energy credit for these types of property terminated after 1982, except that the credit is allowed through 1990 for long-term projects for which certain affirmative commitments (described below) are made.

A 15-percent energy credit is allowed through 1985 for solar, wind, geothermal, and ocean thermal property. Qualified intercity buses and biomass property are eligible for a 10-percent energy credit. For periods beginning on January 1, 1982 and ending on December 31, 1982, a 10-percent energy credit was allowed for chlor-alkali electrolytic cells. No affirmative commitment rule applies to these properties.

Qualified hydroelectric generating property is eligible for an 11-percent credit through 1985. The credit for hydroelectric property is allowed through 1988 under a special affirmative commitment rule.

Congress has not approved a business energy tax credit for a heat pump.

Affirmative commitment rules.—The general 10-percent energy credit is available after 1982 if specified affirmative commitments are undertaken with respect to qualified property that is part of a project with a normal construction period of two years or more. The credit is allowed for property that is constructed or acquired in connection with the project if after 1982 if (1) all engineering studies on the project have been completed before 1983, (2) applications for all environmental and construction permits required to commence construction were filed before 1983, and (3) before 1986, binding contracts are entered into to construct or acquire at least 50 percent of the aggregate cost of all equipment that is specially designed for the project.

The 11-percent energy credit for qualified hydroelectric generating equipment is allowed through 1988 if an application has been

[5] 1981-2 C.B. 7. Solar energy stored in ground water is indirectly derived from sunlight in that the temperature of ground water is closely correlated to the average annual air temperature of a region, because the temperature of ground water reflects the average temperature of surface water and precipitation that recharge the underground water source. This surface water receives its heat energy from the air and land surface that, in turn, are warmed by the sun.

docketed by the Federal Energy Regulatory Commission by January 1, 1986.

Cogeneration equipment.—The term cogeneration equipment includes property which is an integral part of a system for using the same fuel to produce both qualified energy (e.g., steam or heat) and electricity at an industrial or commercial facility at which electricity or qualified energy was produced as of January 1, 1980. Property qualifies as cogeneration equipment only to the extent that such property increases the capacity of the system to produce qualified energy or electricity, whichever is the secondary energy product of the system. Under a statutory limitation, the term cogeneration equipment does not include property that is part of a system using oil or natural gas (or a product thereof) for any purpose other than for startup, backup, or flame control, or a system using fuel comprised of more than 20 percent (on an annual British thermal unit or Btu basis) of oil or natural gas.

Application of the regular investment credit.—If energy property qualifies for the regular investment credit both the regular and energy credits apply. In general, property eligible for the regular investment credit is tangible personal property, excluding buildings and their structural components, that is depreciable. Thus, for example, solar, wind, or geothermal energy air or water heating or cooling systems for air and water (which are structural components of buildings) do not qualify for the regular investment credit under present law. However, in the case of qualified hydroelectric generating property that is a fish passageway, the regular investment credit, as well as the energy credit, is allowed for any period after 1979, without regard to whether such property otherwise qualifies for the regular investment credit.

Solar process heat equipment.—Solar energy property eligible for the business energy credit includes equipment that uses solar energy to generate steam at high temperatures for use in industrial or commercial processes. However, solar process heating equipment that is eligible for the business energy credit may not qualify for the regular investment credit in certain cases. Thus, taxpayers are required to allocate the costs of such equipment between the costs allocable to equipment qualifying for the business energy credit and the costs of equipment qualifying for the regular investment credit.

Biomass property.—In general, to qualify as biomass property eligible for the energy credit, the property must use qualified fuel. For this purpose, qualified fuel includes any synthetic fuel and alcohol, if the primary source of energy for the facility producing the alcohol is not oil or natural gas (or a product of oil or natural gas).

Geothermal energy property.—Taxpayers are allowed a 15-percent energy credit through 1985 for equipment used to produce, distribute, or use energy derived from a geothermal deposit. For purposes of the business energy credit, Treasury regulations provide that the term geothermal deposit has the same meaning as that provided in the regulations for the residential energy credit. The regulations also provide that equipment that uses energy derived from a geothermal deposit is eligible property only if it uses geothermal energy exclusively.

The applicable regulations do not impose an exclusivity rule on other property eligible for the business energy credit. For example, a boiler qualifies as alternative energy property eligible for the credit if a substance other than oil or gas comprises the primary fuel (i.e., if more than 50 percent of the fuel requirement is met by a qualified source, measured in Btus). Similarly, if equipment is used in connection with qualified alternative energy property and nonqualified property, only the incremental cost (*i.e.* the excess of the total cost over the amount that would have been expended if the property were not used for a qualifying purpose) of the property is eligible for the credit.

For purposes of this credit, solar energy property has the same meaning as that provided for purposes of the residential energy credit. Thus, the Internal Revenue Service ruling on equipment that uses ground water as a source of energy under the residential energy credit provisions could be applied to disallow a business energy credit for such equipment.

III. DESCRIPTION OF THE BILLS

1. S. 1193—Senators Symms and McClure

Percentage Depletion for Decarbonization of Phosphate Rock

Explanation of the Bill

Application of thermal energy, below 850 degrees Celsius, to phosphate rock would be deemed to be a mining process. Thus, decarbonization of phosphate rock by thermal process would be subject to percentage depletion.

Effective Date

The bill would be effective for taxable years beginning after 1953.

Revenue Effect

This bill is estimated to reduce fiscal year receipts by less than $10 million a year.

2. S. 1237—Senators Symms, Baker, and McClure

Modification of Definition of Geothermal Energy

Explanation of the Bill

Overview

The bill would provide percentage depletion for all geothermal resources, regardless of whether such resources are exhaustible and without regard to temperature. The bill would also extend the scope of both the residential energy credit and the business energy credit to allow credits for property that uses ineligible energy sources as well as geothermal energy (as defined by the bill). In addition, the bill would allow the full business energy credit for property that uses geothermal energy and any other energy source eligible for the credit.

Definition of geothermal energy

The statutory definition of the term geothermal deposit would be replaced with a new definition of geothermal energy. The bill would define geothermal energy as the natural heat of the earth (at any temperature), which is stored in rocks, an aqueous liquid, or vapor (whether or not under pressure), or any other medium. The bill would retain the requirement that geothermal property be located in the United States or its possessions.

For example, an underground water source that is continually refilled by surface water or precipitation (and therefore inexhaust-

ible) would be eligible for percentage depletion under the bill, without regard to the temperature of the water.

The new definition for geothermal energy would also expand the scope of property that is eligible for residential or business energy credits. For example, a ground water heat pump would qualify as geothermal energy property in every case, because the temperature of the ground water would be irrelevant.

Residential energy credit

The bill would allow the residential energy credit for all of the equipment comprising a system that uses both geothermal energy and an energy source not eligible for the credit, so long as geothermal energy provides more than 80 percent of the energy in a typical year for which the system is designed. If less than 80 percent of the energy is supplied by geothermal energy, the credit would apply to those portions of the system that produce, distribute, transfer, extract, or use energy that is more than 50 percent supplied by geothermal energy (on an annual Btu basis).

The bill would provide a tax incentive to acquire dual-purpose property that serves both a geothermal function and a nongeothermal function. For example, a pipe that distributes hot water from a water heater, as well as hot geothermal water, would be eligible for the residential energy credit, even if only 50 percent of the water distributed were geothermal water.

It is unclear whether a full residential energy credit would be available for a system that is designed to use geothermal energy but that uses other energy comprising more than 20 percent of its fuel supply in a given year. Under the provisions of the bill, it may be sufficient if a system is merely designed to use fuel supplied 80-percent by geothermal sources in a typical year.

Business energy credit

The bill would define geothermal equipment eligible for the business energy credit to include the same kinds of dual-purpose property that are eligible for the residential energy credit.

In addition, a full business energy credit would be allowed for all of the equipment comprising a system that uses both geothermal energy sources and another energy source (such as a biomass source) that is eligible for a business energy credit, subject to the same 80 -and 50-percent usage tests described above. It is unclear whether this provision would affect the present law rules for determining the eligibility of energy property other than geothermal property. For example, because the bill refers to all equipment, it is possible that a taxpayer would be allowed the credit for the total (rather than incremental) costs of qualified alternative energy—property other than property used to serve a geothermal function—if such property is part of a qualified system.

Effective Date

No effective date is contained in the bill.

Revenue Effect

This bill is estimated to reduce fiscal year receipts annually by less than $25 million.

3. S. 1303—Senator Mitchell

Modification of Definition of Solar Energy Property

Explanation of the Bill

The bill would amend the definition of solar energy property to include heat pumps that use solar energy stored in ground water. The new definition of solar energy property would apply for purposes of the residential and the business energy credits.

Effective Date

For purposes of the residential energy credit, the provisions of the bill would apply to taxable years beginning after 1982. For the business energy credit, the bill would apply to periods after 1982 subject to transitional rules similar to those in section 48(m).

Revenue Effect

This bill is estimated to reduce fiscal year receipts annually by less than $20 million.

4. S. 1305—Senators Packwood, Baucus, Durenberger, Matsunaga, Mitchell, Moynihan, Chafee and others

Increase in and Extension of Energy Tax Credits

Explanation of the Bill

Overview

The bill would extend the residential and business energy credits for solar, wind, or geothermal energy equipment through 1990. The business energy credit would also continue to be available for ocean thermal property, qualified hydroelectric generating property, biomass property, and cogeneration property. Property eligible for the extended credits under the bill would continue to be eligible for the credit through 1995 under new affirmative commitment rules applicable to short-term projects, as well as long-term projects. The bill would also make the regular investment credit available for solar or wind energy property and cogeneration equipment that does not qualify for the regular credit under present law.

The bill would repeal the limitation applicable to cogeneration equipment on the use of oil or natural gas. In addition, the bill would expand the scope of the definition of qualified fuel used in biomass property to include methane-containing gas produced by anerobic digestion from nonfossil waste materials at certain facilities.

The definition of geothermal deposits would be amended to lower the temperature requirement from 122 degrees Fahrenheit to 104 degrees Fahrenheit.

Extension of residential energy credit

The termination date of the residential energy credit for solar, wind, or geothermal energy equipment would be extended to December 31, 1990. The credit carryovers would be extended for two years beyond that date (i.e., until December 31, 1992).

Increase in and extension of business energy credit

In general.—The bill would extend the credit for solar, wind, or geothermal property, ocean thermal property, qualified hydroelectric property, biomass property, and cogeneration property through December 31, 1990. Under affirmative commitment rules similar to those of present law, the credit would continue to be allowed through December 31, 1995.

In addition, for periods beginning after June 30, 1983, the bill would increase the business energy credit for solar, wind, and geothermal property to 25 percent. For periods beginning after September 30, 1982, the bill would also increase the credit for ocean thermal property to 25 percent.

Affirmative commitment rules.—The application of the affirmative commitment rules under the bill would not be limited to long-term projects. Thus, these rules would be available for short-term projects. The extended business energy credit would continue to be available for qualified property if (1) all feasibility studies required to commence construction are completed on or before December 31, 1990, (2) applications for all environmental and construction are filed before December 31, 1990, and (3) on or before December 31, 1993 (three years after the termination date), binding contracts are entered into to construct or acquire (a) at least 50 percent of the aggregate cost of all equipment to be placed in service or (b) at least 50 percent of the aggregate cost of all equipment that is specially designed for the project.

Qualified hydroelectric generating property would continue to be eligible for the credit if an application has been filed with the Federal Energy Regulatory Commission before 1990.

Cogeneration equipment.—The bill would repeal the limitation on the use of oil or natural gas for cogeneration equipment. Thus, cogeneration equipment would be eligible for the business energy credit without regard to the kind of fuel used by the system.

Application of the regular investment credit.—The bill would make the regular investment credit available for solar or wind energy property and geothermal energy property that are structural components of a building. Thus, the regular investment credit would be available for solar or wind energy property and geothermal energy property that would not otherwise qualify for the regular investment credit because they are structural components of a building.

Solar process heat equipment.—The qualification of solar energy property for the regular investment credit under the bill would eliminate the allocation problems for solar energy property used for qualifying purposes and to process heat.

Biomass property.—The bill would expand the scope of the definition of biomass property eligible for the business energy credit by permitting the use of methane-containing gas as a qualified fuel.

Under the bill, the term qualified fuel would include methane-containing gas produced by anerobic digestion from nonfossil waste materials at farms or other agricultural facilities, and at facilities for the first processing of agricultural products (such as packing plants and canneries).

Geothermal deposits

The bill would lower the temperature requirement provided by Treasury regulations, so that deposits with a temperature of 104 degrees Farenheit (40 degrees Celsius) would qualify as geothermal deposits for purposes of the residential and business energy credits.

Effective Date

Under rules similar to those in section 48(m), (1) the affirmative commitment provisions of the bill would apply to periods beginning after December 31, 1982, and (2) the provisions relating to the limitation on the use of oil or gas for cogeneration equipment, the application of the regular investment credit, methane-containing gas, and the temperature of geothermal deposits generally would be applicable to periods beginning after June 30, 1983.

No effective date is provided for the provision that extends the residential energy credit or the provision that increases and extends the business energy credit.

Revenue Effect

This bill is estimated to reduce fiscal year receipts by $174 million 1984, $126 million in 1985, $390 million in 1986, $1,127 million in 1987, and by $1,281 million in 1988. The estimate that the provisions are effective after October 1, 1983.

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